



Argentina's Defaulted Sovereign Debt: Dealing with the "Holdouts"

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Summary

In December 2001, following an extended period of economic and political instability, Argentina suffered a severe financial crisis, leading to the largest default on sovereign debt in history. It was widely recognized that Argentina faced an untenable debt situation that was in need of restructuring. In 2005, after prolonged, contentious, and unsuccessful attempts to find a mutually acceptable solution with its creditors, Argentina abandoned the negotiation process and made a one-time unilateral offer on terms highly unfavorable to the creditors. Although 76% of them accepted the offer, a diverse group of "holdouts" opted instead for litigation in hopes of achieving a better settlement in the future. Although Argentina succeeded in reducing much of its sovereign debt, its unorthodox methods have left it ostracized from international credit markets for nearly a decade and triggered legislative action and sanctions in the United States.

Argentina still owes private creditors \$20 billion in defaulted debt and \$10 billion in past-due interest, as well as \$6.2 billion to Paris Club countries. Of the disputed privately held debt, U.S. investors hold approximately \$3.0 billion. Some of the more vocal investor groups have lobbied Congress to pressure Argentina to reopen debt negotiations. Some Members of Congress have introduced punitive legislation in both the 110th and 111th Congress, but to date it has not received any legislative action. Nearly five years after the original debt workout, however, a confluence of circumstances has persuaded Argentina to restructure the holdout debt, particularly the need to secure long-term public financing.

On December 16, 2009, Argentina filed a registration statement and prospectus to issue \$15 billion in bonds, the proceeds of which will be used to finance an exchange of defaulted debt. The terms of exchange were not included and are not expected until late January 2010. Some analyses speculate that the structure of the new exchange will be similar to the one offered in 2005, which would entail a discount of 65% from the face value of the bonds, with past due interest capitalized and financed separately. Given that Argentine law prohibits the new exchange from offering better terms than the 2005 offer, and that bondholders who participated in that exchange benefitted from additional payments based on Argentina's strong economic growth, it appears likely that the new offer will be the less favorable of the two.

For Argentina, a successful restructuring requires a sufficiently large participation rate for the courts to set aside existing judgments and attachment orders. This action would allow Argentina renewed access to the international credit markets. Historically, sovereign debt workouts with at least a 90% participation rate have achieved this goal. Since holdouts compose 24% of the original bondholders, a 60% participation rate of this group would allow for the total participation rate to reach the 90% threshold. If the exchange succeeds, Argentina will have completed a debt restructuring with the deepest write-off of principal in history. The original bondholders were severely hurt by this deal, but so was Argentina by the crisis. It appears that nothing can be done for the original investors who have traded their bonds. If there is a legacy to the Argentine case, it may be in the changes to bond contracts that seek to improve outcomes for creditors. One option is collective action clauses (CACs) in bonds, which require all creditors to bargain collectively, with a compulsory majority decision applicable to all bondholders. This provision may allow for more coordinated creditor responses, which could increase their bargaining leverage, allow for more equitable treatment of all bondholders, and lead to a far quicker resolution to any future sovereign default.

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Introduction

In December 2001, following an extended period of economic and political instability, Argentina suffered a severe financial crisis, leading to the largest default on sovereign debt in history. In 2005, after prolonged, contentious, and unsuccessful attempts to find a mutually acceptable solution to restructuring the debt, Argentina abandoned the negotiation process and made a one-time unilateral offer on terms highly unfavorable to creditors. Although 76% of them accepted the offer, a diverse group of "holdouts" opted instead for litigation in hopes of achieving a better settlement in the future. Argentina still owes private bondholders \$20 billion in defaulted debt and \$10 billion in past-due interest. It is also in arrears to the United States and other governments on \$6.2 billion in loans. Although Argentina succeeded in reducing much of its sovereign debt, its unorthodox methods have left it ostracized from international credit markets for nearly a decade and triggered legislative action and sanctions in the United States.

The lingering effects of the debt default have become a legacy problem for Argentina, but circumstances have evolved to a point where the government decided in October 2009 to restructure the remaining holdout debt. Argentina has made preliminary filings at the U.S. Securities and Exchange Commission (SEC) for a debt exchange, and although there a number of internal political complications that may delay the debt swap, it is expected to move forward in the first quarter of 2010. This report provides background, analysis, and implications of Argentina's proposal to resolve its defaulted sovereign debt.

Background to the Current Debt Restructuring

Argentina's 2001 debt crisis resulted from many factors. For the most part, Argentina fell victim to its own economic policies, but these were compounded by questionable lending and policy advice by the International Monetary Fund (IMF), a global recession, and international credit markets determined to chase high-yielding debt with inadequate regard to risk. Together, these factors propelled Argentina toward a position of unsustainable debt that ended in an unprecedented default and restructuring scheme.

The 2001 Financial Crisis

Argentina's 2001 financial crisis has its roots in a history of untamed fiscal policy, the Achilles' heel of Argentine economic strategy for most of the 20th century. Argentina has long relied on fiscal largesse as a basic policy tool, covering its shortfalls by printing currency or relying on more creative alternatives to expand the money supply. This approach to fiscal governance, as would be expected, led to recurring bouts of high inflation and indebtedness, typically followed by temporary efforts to stabilize prices. In the 20th century, this policy culminated with the hyperinflation of 1989-90, which toppled the Alfonsín government, bringing Carlos Menem to the Presidency along with his well-known Minister of Economy, Domingo Cavallo.¹

¹ Gerardo della Paolera, Maria Alejandra Irigoin, and Carlos G. Bózzoli, "Passing the Buck: Monetary and Fiscal Policies," in *A New Economic History of Argentina*, ed. Gerardo della Paolera and Alan M. Taylor (Cambridge: Cambridge University Press, 2003), pp. 72-74. Inflation hit a high of nearly 200% per month in 1990 and as noted by (continued...)

The Menem-Cavallo cure for chronic inflation was the now infamous “convertibility plan.” Enacted on April 1, 1991, it set the stage for the crisis that would emerge a decade later. The plan legally guaranteed the convertibility of pesos to dollars at a one-to-one fixed rate and limited the printing of additional currency only to amounts supported by its reserve position (which could fluctuate with the amount of dollars entering or leaving the country). Upholding this promise, however, required that monetary and fiscal policies also be constrained—the money supply could not be expanded to cover deficits. Therefore, to preserve this system, deficits either had to be eliminated or financed through debt.

At first convertibility worked well; it forced fiscal and monetary discipline on the government, which combined with strong economic growth, reduced inflation and debt service. Cracks in Argentina’s economic policy, however, soon began to appear. The main problem was that fiscal deficits were not contained at either the provincial or national levels to thresholds required to support the convertibility plan. By 1993, debt began to grow, compounded by the practice of rolling it over. From 1995 to 2001, the debt service ratio grew from 30% to 66%.² The Argentine peso soon became greatly overvalued, reducing Argentina’s competitiveness and ability to export, with predictable declines in public revenue.

Fiscal balances further deteriorated with a strengthening dollar (to which the peso was linked), competitive devaluations by its major regional trading partners (most importantly Brazil), and falling commodity prices. Argentina was already entering a four-year recession when the global downturn arrived in 1999, causing public revenue to fall further. The weaknesses of the convertibility plan’s strict policy constraints were now exposed. It has been likened to a straitjacket precisely because the Argentine government had no policy room to address the recession. The convertibility plan, by definition, prohibited devaluing the peso to increase exports, and excessive debt eliminated the option for a fiscal stimulus to counter the economic downturn. The third option, reducing government spending, only guaranteed a deeper recession. By this point, there was already little chance of Argentina avoiding financial disaster.³

In retrospect, it is also clear that in addition to Argentina’s policy choices and an increasingly hostile global economy, actions by the international community were complicit in deepening the severity of Argentina’s financial crisis. Global credit markets lent generously to Argentina, even after risk factors began to rise to worrisome levels. Investment bank and credit agency reports overstated Argentina’s strengths.⁴ Also, the IMF agreed to numerous lending arrangements made between 1991 and 2001 based on promised changes in Argentine policies and economic assumptions and projections that ranged from being overly optimistic to unrealistic. U.S. policy for much of the time could not be divorced from those of the IMF. Without the IMF, the convertibility plan would have collapsed much sooner. By its own admission, the IMF made repeated mistakes in surveillance, conditionality, and economic analysis that resulted in lending

(...continued)

these and other authors, high inflation is costly. It reduces the real value of money with the resulting loss of purchasing power equivalent to a large “inflation tax” on society as a whole.

² Ibid., and CRS Report RS21072, *The Financial Crisis in Argentina*, by J. F. Hornbeck. Debt service ratio = public sector debt/exports.

³ Ibid, pp. 2-4. Argentina required a more, not less, competitive exchange rate to attract foreign currency needed for debt service. As long as the peso was pegged to an appreciating dollar, this was not possible, and with the addition of a procyclical fiscal policy, Argentina eventually was unable to cover its debt obligations.

⁴ Paul Blustein, *And the Money Kept Rolling in (And Out): Wall Street, The IMF, and the Bankrupting of Argentina*. (New York: Public Affairs, 2005), pp. 5-8, 31-35, 198-200.

too much for too long into an untenable situation. Many economists would later argue that Argentina would have been better off had the IMF ended its support and pushed for debt restructuring much earlier.⁵

Notwithstanding the many factors that compounded Argentina's financial problems, the government's economic policies were the major cause of the economic crisis. Faced with the unsustainable situation described above, and falling international credibility, Argentina was unable to roll over its debt. Financial panic and political unrest ensued. On December 20, 2001, President de la Rúa resigned and six days later, a new government defaulted on Argentina's sovereign debt. Soon thereafter the government abandoned the convertibility plan and devalued the peso. The Argentine default left the government in arrears with a number of international creditors. It owed private investors \$81.8 billion, the Paris Club countries \$6.2 billion,⁶ and the IMF \$9.8 billion. Addressing the large private-sector debt was Argentina's most pressing problem, which was undertaken in a highly unusual manner.

The Debt Restructuring of 2005

The severe financial crisis hit Argentina hard. Between capital flight and the large peso devaluation, much of the country's wealth evaporated nearly overnight. Poverty and unemployment skyrocketed, leading to street protests and political unrest. As Argentina turned to address its debt problem, it argued that bondholders would have to share in the misery that affected the whole country, and that the government had a moral duty to ensure this outcome. It was, as many argued, a matter of equity that the write-down on bonds be historically high, particularly given that continued lending from the IMF, investment banks, and foreign governments at a time when it was clear that Argentina faced an impending crisis had only compounded the financial problems. Perhaps most importantly, Argentina was simply in no position to repay such massive debt.⁷

A sovereign default means the government is no longer willing or able to pay the debt it has incurred in the international markets. Sovereign defaults occur periodically and are typically worked out in what amounts to a consensual understanding between creditors and debtors. This type of understanding usually takes the form of a debt restructuring, which involves a formal and legal change in the contractual arrangements of the debt, such as reducing the face value of the obligations, issuing new bonds with lower interest rates and longer maturities, and capitalizing overdue interest, usually at a sizable loss to bondholders. Historically, a "successful restructuring" typically has had a 90% or greater participation rate (there are always some holdouts) by offering no less than 50% on the net present value of the debt. Usually, this process unfolds with the

⁵ The dominant view at the IMF, despite some strong internal opposition, was that the IMF could not abandon Argentina for fear of being viewed as the cause of its economic collapse. Ibid, pp. 100-106, 134, 140-41, 157 and CRS Report RL32637, *Argentina's Sovereign Debt Restructuring*, by J. F. Hornbeck.

⁶ The Paris Club is a voluntary, informal group of 19 creditor nations who have agreed to act with a common approach to negotiate debt relief for developing countries unable to meet their external obligations. Members of the Paris Club agree to restructure and/or reduce official debt owed to them on a case-by-case basis, provided certain conditions are met. See, CRS Report RS21482, *The Paris Club and International Debt Relief*, by Martin A. Weiss.

⁷ Juan Pablo Bohoslavsky and Kunibert Raffer, "¿Qué Hacer con los Reclamos de los Acreedores Holdouts?," *Economía*, January 24, 2008 and Universidad de Buenos Aires. Plan Fénix. *La Argentina y su Deuda Externa: En Defensa de los Intereses Nacionales*. July 2004. <http://www.econ.uba.ar/planfenix>.

assistance of the IMF in setting macroeconomic targets that form the basis for a mutual understanding of a country's ability to repay its debt.⁸

Argentina began the debt restructuring process in 2002, negotiating with the IMF and investors for three years to find a solution that it felt was commensurate with its deeply diminished economic and social reality. Facing a huge debt burden, Argentina adopted a hard line toward all parties, insisting on a large write-down of principal for private creditors and postponing action on Paris Club and IMF debt. After years of negotiation, which were criticized by both sides, Argentina eventually determined that it had reached an impasse with creditors and decided to act on its own. It suspended its agreement with the IMF and filed for a one-time unilateral offer with the SEC to settle with private creditors. The Argentine legislature codified this commitment, passing the so-called "Padlock Law" (Ley Cerrojo), which prohibited the government from reopening the exchange or making any kind of future offer on better terms.

On January 14, 2005, Argentina opened the bond exchange for six weeks hoping to reach a final settlement on the \$81.8 billion face value of debt plus \$21.4 billion of past due interest (PDI). The default was unprecedented for its size (\$103.2 billion), lengthy resolution (over three years), low recovery rate (30% on a net present value basis, including PDI), and large residual holdout (24% of creditors). Bondholders and the IMF criticized Argentina for engaging in a process that stretched (creditors would argue flaunted) the accepted guidelines of sovereign debt negotiations. Nonetheless, of the \$81.8 billion face value of debt, \$62.2 was exchanged for \$35.2 billion of new bonds. The Argentine government, however, was not able to settle the matter fully because \$19.6 billion of bonds (24% of eligible securities) were not tendered and remain in dispute along with accrued interest, \$6.2 billion of arrears to the Paris Club, and \$9.8 billion owed to the IMF.⁹

Argentina has addressed this remaining debt in one of two ways. In 2006, it decided to repay in full the \$9.8 billion owed to the IMF, relieving the government of any pressure to follow IMF policy constraints. Alternatively, Argentina has so far declined to restructure or repay debt owed to the Paris Club countries or holdouts. Holdout creditors have pursued litigation to force repayment, with the resulting judgments and attachment orders effectively precluding Argentina from borrowing in the international capital markets until the defaulted bonds are repaid or restructured.¹⁰ For years, neither of these responses affected Argentina's determination to deviate from its policy of "financial independence." Strong economic growth until the 2008 global financial crisis and reliance on various stop-gap measures (details below) to meet financing gaps have allowed Argentina to rebuff attempts at forced resolution.

Argentina made a first effort to restructure the remaining defaulted debt in September 2008. As President, Cristina Fernández de Kirchner announced that Argentina would seek to repay the Paris Club debt out of its approximately \$47 billion of international reserves and signed an agreement with a three-bank consortium (Barclays Capital, Deutsche Bank, and Citibank) to

⁸ For examples of five recent developing country defaults that had participation rates of 93%-98%, see: Marcus Miller and Dania Thomas, "Sovereign Debt Restructuring: The Judge, the Vultures, and Creditor Rights," *The World Economy*, vol. 30, no. 10 (October 2007), p. 1497.

⁹ CRS Report RL32637, *Argentina's Sovereign Debt Restructuring*, by J. F. Hornbeck. p. 11-13 and Fitch Ratings. *Argentina: Rapprochement with Creditors and Sovereign Ratings*. Special Report. November 19, 2009, p. 2.

¹⁰ Argentina's international bonds were issued under eight different jurisdictions, including New York and a number of foreign countries. Some 38% of the untendered bonds were denominated in U.S. dollars. Those issued under the jurisdiction of the State of New York are subject to U.S. law. Miller and Thomas, "Sovereign Debt Restructuring: The Judge, the Vultures, and Creditor Rights," pp. 1492-1493, 1496, and 1502.

consider their offer to renegotiate with private holdout creditors. The simultaneous onset of the global financial crisis, however, put an end to the potential deal and any hope of meeting short-term financing needs with international borrowing.¹¹

U.S. Responses to Argentina's Debt Repudiation

Argentina owes approximately \$29 billion of bond principal and interest arrears to private investors and \$6.2 billion of loans to Paris Club countries, including nearly \$500 million in arrears to the United States. Private bondholders, the United States Government, and Members of Congress have each taken actions to encourage Argentina to repay these debts.

Private Sector Responses

In the eyes of institutional creditors, the 2005 Argentine restructuring set a precedent that could not be condoned, even though a majority of bondholders accepted the terms. Although Argentina continues to argue that the restructuring was a negotiated solution, it was not a mutually agreed one. Bondholders had to accept or reject the offer with the alternative being no restitution at all. Some holdouts sought legal remedies in the United States and other countries, as well as at the World Bank's International Center for the Settlement of Investment Disputes (ICSID). Creditors argued that Argentina had not fulfilled its obligations under either the bond contracts or its bilateral investment treaty with the United States.

Because many bonds in the hands of holdouts are still being traded, ownership is difficult to track. They were originally marketed in local country currencies: 58% in Euros, 38% in U.S. dollars, 2% in Argentine pesos, and the remaining 2% in other currencies. U.S. ownership is still estimated at approximately \$3 billion. Funds that have brought suit against Argentina in U.S. courts have made claims on \$2 billion of principal.¹² Because most of these funds are legally organized in countries known for their lack of financial transparency, it is difficult to state with certainty the nationality of ownership.¹³

Depending on the owner of the bonds, the goal of the litigation strategy differs. Institutional funds representing corporate and investment banks generally seek improved terms on the exchange. Funds representing retail (individual) investors, mostly European, also have held out for a better settlement. Hedge funds and so-called "vulture funds," which purchase risky assets in the secondary market at highly discounted prices, typically sue for full recovery. Their "holdout" strategy can be highly profitable for investors with patience, realizing capital gains on undervalued bonds, often purchased after the default, and potentially receiving full restitution of interest and principal if the holdouts dwindle to a sufficiently small percentage of the total unresolved debt.¹⁴

¹¹ Jude Webber, "Argentina Mulls Delay to \$6.7 billion Debt Repayment," *Financial Times*, October 11, 2008.

¹² Correspondence with U.S. Department of State, January 12, 2010.

¹³ A few funds are legally incorporated in the United States, the rest in the Cayman Islands, British Overseas Territories, Turks and Caicos, British Virgin Islands, Switzerland, and Luxembourg. *Main Judgments and Pre-Judgment Claims Against the Argentine Republic*, provided by the Embassy of Argentina, December 2009.

¹⁴ Miller and Thomas, "Sovereign Debt Restructuring: The Judge, the Vultures, and Creditor Rights," p. 1497.

Litigation has applied considerable leverage on Argentina, resulting in legal judgments and attachment orders that have precluded Argentina from raising funds in the international credit markets.¹⁵ For example, approximately \$105 million of Argentina's Central Bank reserves are frozen in the Federal Reserve Bank of New York and another \$2 billion of global bonds backing guaranteed loans are on hold at the Depository Trust Company.¹⁶ Most recently, on July 12, 2010, a U.S. judge froze \$1.7 million of Argentine central bank reserves held at the Federal Reserve Bank of New York because the Fernández government attempted to use them to guarantee payment of debt coming due in 2010, thereby making them eligible for attachment (see below).

Because the Argentine government did not recognize any creditor groups as negotiating partners, the hedge and "vulture" funds have also served as one form of admittedly imperfect investor coordination. While they bring greater pressure to bear on Argentina because of their collective action, their prolonged delaying tactics in seeking full restitution can clash with other investors wishing to pursue a settlement strategy.¹⁷

U.S. Government Responses

With Argentina's default on Paris Club debt, including nearly \$500 million owed to the United States government, a number of sanctions have been invoked automatically as defined in U.S. law. Numerous U.S. agencies are prohibited from lending to a country that is in arrears on its debt to the U.S. government. These include the Export-Import Bank, Overseas Private Investment Corporation, and the U.S. Trade and Development Agency. The U.S. military is prohibited from offering Foreign Military Financing, Excess Defense Articles through 505 Drawdown authority, and full use of Global Peacekeeping Operations Initiative funding. In addition, all foreign assistance is prohibited except for certain programs related to countering terrorism and trafficking in narcotics or persons, as well as International Military Education and Training funding.¹⁸

Legislative Responses

In Congress, some Members have responded to U.S. creditor concerns with the introduction of punitive legislation against Argentina. The Judgment Evading Foreign States Accountability Act of 2009 (H.R. 2493) was introduced in the 111th Congress on May 19, 2009, and driven in part by the American Task Force Argentina (AFTA), a private lobby group representing various constituents, including hedge and "vulture funds."¹⁹ The bill cites Argentina's decision to ignore judgments against its actions as detrimental to U.S. investors and undermining the United States legal system. The bill's stated goal is to protect future investors by motivating those countries identified as "judgment evading foreign states" to "raise their standards of behavior." It would deprive such states and any state-owned corporations from issuing debt in the U.S. capital

¹⁵ There are over 100 judgments against Argentina and many include attachment orders in which the courts can seize funds from any future debt that might be issued by Argentina, effectively prohibiting access to the international credit markets. A list of claims against Argentina is summarized in, *Main Judgments and Pre-Judgment Claims Against the Argentine Republic*, provided by the Embassy of Argentina, December 2009.

¹⁶ Correspondence from U.S. Department of State, January 12, 2010.

¹⁷ Amrita Dhillon, Javier García-Fronti, Sayantan Ghosal and Marcus Miller, "Debt Restructuring and Economic Recovery: Analysing the Argentine Swap," *The World Economy*, vol. 29, no. 4 (April 2006), pp. 392-393.

¹⁸ Correspondence from U.S. Department of State, January 12, 2010.

¹⁹ *Ibid.*, and Mark Weisbrot, "Vulture Funds Lobby Against Argentina," *América Latina en Movimiento*, August 6, 2009. <http://alainet.org/index.phtml>

markets and would require that any future debt offerings carry written warnings that they have failed to satisfy outstanding judgments against them. The bill would also require that any request for bilateral or multilateral assistance be accompanied by a statement identifying the country as a "judgment evading state." To date, Congress has not acted on this bill.

Argentina's Debt Profile and Rationale for Restructuring (Again)

As may be seen in **Table 1**, the portion of "holdout" debt plus that owed to the Paris Club represents currently 21% of Argentina's total public sector debt. For eight years, Argentina has been unable or unwilling to find a solution that would restructure this portion of debt, but circumstances have changed. Argentina may have both the political will and financial incentives to negotiate a final solution to its long-outstanding debt issue.

Table 1. Argentina: Total Public Sector Debt, 2009

(in \$ billions)

Debt Category	Amount	Percent
Performing Debt:	133.9	79.0%
Bonds and Bills	91.2	
Loans and Other	42.7	
Other	0.5	
Nonperforming Debt:		
Private ("holdout"):	29.2	17.3%
Falling Due	5.2	
Past Due:		
Principal	15.0	
Interest	9.0	
Paris Club:	6.2	3.7%
Principal	5.1	
Interest	1.1	
Total Public Sector Debt	169.8	100.0%
Total Public Debt/GDP	59.4%	

Data Source: Institute of International Finance and Government of Argentina, Ministry of Economy and Public Finances.

There are three major incentives for Argentina to resolve its outstanding debt issues. First, in the medium to long run, Argentina, like many countries, will need to borrow in the international capital markets. Although its financing gap for fiscal year 2010 is reportedly covered, the steep decline in 2009 fiscal revenue relative to expenditures points to a deteriorating fiscal position. The fiscal balance has fallen from a surplus of 1.4% of gross domestic product (GDP) in 2008 to

an expected deficit of 1.5% of GDP in 2009 (see **Table 2.**) By initiating a restructuring process now, when financial requirements are not an immediate threat, Argentina may have the time to make the political and financial arguments for reengaging the international credit markets at reasonable rates.²⁰

Table 2. Argentina: Selected Economic Indicators

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
GDP Growth (%)	-0.8	-4.4	-10.9	8.8	9.0	9.2	8.5	8.7	7.0	0.7
Overall Fiscal Balance (%)	-3.6	-6.8	-2.0	0.9	3.7	2.1	1.9	1.1	1.2	-1.5
Primary Fiscal Balance (%)	0.4	-1.3	0.7	2.8	5.3	4.4	4.0	3.4	3.3	1.0
Inflation Rate INDEC (%) ^a	-0.7	-1.5	41.0	3.7	6.1	12.3	9.8	8.5	7.2	5.5
Inflation Rate others (%) ^a								15.0	25.0	17.0
Current Acct Balance (% GDP)	-3.1	-1.4	8.5	6.3	2.1	2.9	3.6	2.8	2.1	na ^b
International Reserves (\$ bn)	32.5	15.3	10.4	13.8	19.3	27.3	31.2	45.7	46.2	47.5
Public Debt (% GDP)	45.7	53.7	166.4	138.7	127.3	73.9	64.0	56.1	48.8	59.0
International bond Issues (mn) ^c	13,468	2,711	0	100	200	540	1,896	3,256	65	na ^b

Source: United Nations Economic Commission on Latin America and the Caribbean (ECLAC). *Estudio Económico de América Latina y el Caribe 2008-2009*, July 2009, Credit Suisse, *Argentina, an Improving Story*, September 24, 2009, Government of Argentina, Ministry of Economy and Public Finances (for debt figures).

- a. Instituto Nacional de Estadística y Censos – Argentina’s official government statistical office, which has come under criticism for grossly understating inflation rates since 2007. Adjusted inflation rates have been added on the line below to reflect private sector estimates of annual inflation rates since 2007.
- b. na = not available
- c. Includes sovereign, financial sector, and other commercial debt.

Second, opportunities for ad hoc financing may be limited. In the absence of access to international capital markets, Argentina has met its financial needs by placing debt with domestic government agencies, restructuring domestically held debt, selling bonds directly to the government of Venezuela, and nationalizing private pension funds. In a recent example, on December 14, 2009, President Fernandez attempted to create a \$6.6 billion Bicentennial Fund for Stability and Debt Reduction. The fund would set aside money to guarantee early repayment for debt coming due in 2010. While on the surface it may seem to reinforce Argentina’s commitment to meet its debt service, it presents numerous problems because the commitment would be financed from Central Bank reserves, which the government would purchase with 10-year government bonds. In addition to undermining the independence of the Central Bank, this strategy diminishes Argentina’s international reserve position and allows the government to defer difficult decisions on fiscal adjustment.²¹

Using Central Bank reserves to guarantee debt payments is an unusual move and has been challenged by the president of the Central Bank of Argentina and the Argentine Congress. In fact,

²⁰ The official Argentine position stresses that the need for financing is not the major incentive for restructuring its debt, but fiscal reality argues to the contrary. Ministerio de Economía y Finanzas Públicas. *Boudou Explicó en Diputados los Alcances de la Suspensión de la Ley Cerrojo*. October 28, 2009.

²¹ International Monetary Fund, *Global Markets Monitor*, Washington, D.C., December 16, 2009, p. 4.

the Central Bank president has refused to transfer the funds to the Argentine treasury, to which President Fernández responded with a presidential decree dismissing him. At this juncture, the problem escalated into a constitutional crisis because the use of Central Bank funds, as desired by President Fernández, falls under the sole purview of the Central Bank, and responsibility for the dismissal of the Central Bank president, also the wish of the President, falls to the legislative branch. A federal court ruling reinstated the Central Bank president and currently the issue is unresolved from both political and financial perspectives.²²

A U.S. federal court also ruled that the attempted use of Central Bank reserves to meet current fiscal obligations in effect meant that the President viewed the Central Bank as capable of acting as a financial agent of the Argentine Government. Therefore, the court also ruled that Central Bank reserves would be subject to attachment. This action caused markets to be less, rather than more assured of Argentina's institutional guarantees to meet its financial obligations.²³

Third, market conditions are favorable for placing debt. Interest rates are low by historical standards and liquidity is high. There may be ample appetite for Argentina's higher yielding bonds.

By some measures, Argentina is also in better financial shape to address repudiated debt than it was during the 2001 crisis or the 2005 restructuring. Argentina has a positive current account balance and has increased its international reserves from \$10.4 billion in 2002 to \$47.5 billion in 2009. During the 2003-2008 economic recovery, Argentina had an average annual growth rate of 8.5% and the increased revenues have until recently allowed it to maintain a primary surplus of 2.8% or higher (see **Table 2**). The primary surplus reflects the fiscal surplus after non-debt expenditures have been paid, and so is a measure of resources available exclusively for debt service. Because of the global financial crisis, however, the primary surplus fell to 1.2% of GDP in 2009, levels inadequate to reduce Argentina's total public debt. Still, Argentina is financially stronger than during the 2001 crisis, perhaps suggesting that the imperative and opportunity for restructuring defaulted debt may have converged.

Restructuring the Holdout Debt

A sovereign debt restructuring is a complicated matter and in Argentina's case the government must address three core and interrelated conditions: (1) negotiate a solution with private debt holdouts; (2) repay or reschedule Paris Club debt; and (3) reengage the IMF. A successful conclusion for Argentina seems unlikely without meeting all three goals to some degree, in part because they are interrelated in many ways. First, the Paris Club generally does not entertain a sovereign debt restructuring proposal without the debtor country undergoing an Article IV review of its economy (standard practice for all IMF country members), and having an IMF lending program in place. Among other goals, the Article IV review provides one presumably unbiased assessment of Argentina's economic health and ability to repay its debt, although Argentina has been particularly distrustful of the institution since the 2001 crisis. The IMF, however, is unlikely to consider a formal program until the "holdout" creditors have been offered a proposal.

²² Jude Webber, "Argentina Debt Battle Intensifies," *Financial Times*, January 11, 2009, p. 3.

²³ Carlos Pagni, "Reviewing the Payment with Reserves for Fear of an Embargo," *La Nación*, January 11, 2009.

The IMF review is important in part because it may affect Argentina's future borrowing rates. A clean IMF review, however, is not guaranteed. Among other issues, the IMF has registered grave concerns over the politicization of Argentina's economic data reporting. The national office of statistics, Instituto Nacional de Estadística y Censos (INDEC), has been criticized in particular for misrepresenting national inflation data.²⁴ The discrepancy can be seen in **Table 2**. By underreporting increases in price levels, the Argentine government can reduce public sector costs by, for example, having lower inflation-based price adjustments where applicable and borrowing domestically at artificially lower nominal interest rates. Correcting data reporting is important for making a valid assessment of Argentina's ability to pay future debt obligations. In recent months, INDEC has been reforming its statistical reporting methods, but recent estimates suggest it is capturing only 70% of total inflation²⁵ and the IMF is unlikely to provide a fully positive review of Argentina if this problem is not corrected.

These issues raise two important questions: is Argentina willing to accede in whole or in part to these requirements, and if so, what is the sequence that would make the most sense to ensure that all three conditions are met? Press reports suggest Argentina is prepared to agree to an IMF Article IV review, but is not interested in establishing a formal lending arrangement. This could delay or inhibit IMF and Paris Club support for a restructuring proposal.²⁶

Three major actions have been completed that allowed the new bond exchange to move forward: (1) President Cristina Fernández de Kirchner has lent full support for the deal; (2) on November 18, 2009, the Argentine legislature suspended that portion of the 2005 law that prohibits reopening a debt restructuring offer; and (3) in December 2009, the Argentine government filed a preliminary prospectus with the SEC to issue bonds to cover the cost of retiring defaulted debt.

Argentina is likely to consider a future exchange "successful" if it can entice a participation rate that will set aside most legal judgments, which would allow for its renewed access to international credit markets. Historically, sovereign debt workouts that involve a 90% voluntary participation rate or higher have been able to achieve this goal. A participation rate of 60% or higher of the holdout group would allow for the total participation rate, including the 2005 participants, to reach this threshold. Reportedly, the three-bank consortium organizing the offer represents 40%-50% of the holdouts. Therefore, Argentina would need only an additional 10%-20% of holdouts to reach this goal. Given that there are many funds that have acquired their Argentine bonds in the secondary market at highly depressed prices, it is possible that they would be willing to exchange these bonds, allowing the 90% threshold to be achieved.

The 2009 Proposed Exchange

On December 16, 2009, Argentina filed a registration statement and prospectus at the SEC for the issue of \$15 billion in bonds. If approved by the SEC and the bank consortium that represents a large portion of holders of defaulted debt, the proceeds would be used to retire the last of the outstanding defaulted debt. The terms of exchange were not included and are not expected until

²⁴ Helen Parsons, Carola Sandy, and Igor Arsenin, *Argentina: Rising Tide Lifts All Boats*, Credit Suisse, New York, NY, September 17, 2009, p. 1.

²⁵ International Monetary Fund, *Global Markets Monitor*, Argentina, December 14, 2009, p. 4.

²⁶ Credit Suisse, *Argentina: Friendlier Noises*, September 1, 2009, p. 3.

the end of January 2010 at the earliest. Given that Argentine law still prohibits any new exchange from offering better terms than the 2005 offer, it is uncertain how investors will respond.²⁷

Press reports speculate that the structure of the new exchange will be similar to the one offered in 2005.²⁸ If so, it would include a menu of bonds (discount, par, and possibly some type of quasi-bond option) that would provide an average discount of approximately 65% on the face value of defaulted bonds. This amounts to the issuance of approximately \$7 billion of new bond debt to retire \$20 billion of existing defaulted bonds. Past due interest may be fully capitalized and could be financed with these or separate bonds. Many sources cite the possibility of creditors having to accept \$1 billion of new debt to provide Argentina with new funds.

If similar to the 2005 offer, bond maturities could vary from 7 to 25 years, or more. In addition, there is speculation that there may be a GDP warrant similar to the one offered in 2005. The warrant would be a separate enticement attached to the bonds allowing additional payments when economic growth exceeds pre-defined thresholds. It proved to be a valuable addition to the bonds issued in 2005. Argentina reportedly has allotted \$15 billion in its debt schedule to finance the exchange, which may include restructuring the Paris Club portion of defaulted debt.

Outlook

Argentina may be on the verge of finally completing, largely on its own terms, the restructuring of the largest and most controversial default on sovereign debt in history. There was little disagreement that in 2002 Argentina faced a desperate financial situation that required a radical restructuring of debt, including a large write-off by bondholders. The historical precedent for such an outcome has been set on many occasions. The Argentine debt restructuring framework, however, involved methods, processes, and a deep discount that were notably unprecedented. In addition, although Argentina negotiated for years with creditors under IMF guidelines, it ultimately made a "take it or leave it" offer, with the promise that no better offer would be made.

Ultimately, Argentina's debt restructuring was costly for all parties, raising a lingering question of whether it represents a new template for debtor countries in the future. For many reasons, it arguably is not. Perhaps the major lesson for Argentina is that a perpetual disregard for fiscal responsibility can have dramatic long-term economic, social, and political consequences. At the financial level, the costs to Argentina have been severe, particularly its inability to access international credit markets. This cost was compounded by Argentina's resorting to creative, but unorthodox financing mechanisms that could not adequately replace conventional financial arrangements. If the new debt restructuring allows Argentina access to international credit, the bonds likely will carry higher interest rates than many other countries. This situation does not seem like a desirable model for other countries contemplating a sovereign default.

The Paris Club so far has also been a loser in this case. The Argentine case demonstrates that national governments may be limited in their efforts to influence a sovereign nation that is

²⁷ The November 18, 2009 law suspending the prohibition on making a new bond exchange states, "the offered financial terms and conditions cannot be equal nor better than creditor offers made under the debt restructuring decree 1.735/04." See: Clarin.com. *Piden Suspender un Año la Ley Cerrojo para Acelerar el Canje*. November 27, 2009.

²⁸ Martin Kanenguiser, "Inminente Anuncio de Canje de los Bonos que Sigue en Default," *La Nacion*, October 17, 2009, p. 2.

determined to delay or deny debt repayment. For the United States, neither sanctions nor legislative proposals have had any noticeable influence on Argentina, and actually may have reinvigorated Argentina's resolve to stay the course of default as long as possible. In the end, it was the international markets that appeared to have the greatest leverage on Argentine decision making.

Creditors also clearly suffered, with the exception of "vulture funds" and others able to gain on trading highly discounted debt in the secondary markets. Creditors as a whole are best served by a quick and mutually agreed debt workout, which historically has led to better and more equitable terms than those offered by Argentina. The lack of collective action presented a serious problem in this case. The financial markets have since responded in ways that seek to avoid a second occurrence of a prolonged, costly, unilateral workout.

The most important development along these lines is the adoption of collective action clauses (CACs) in virtually all sovereign debt. These clauses allow for a majority of bondholders to bargain collectively and require a minority holdout group to capitulate to the majority negotiated solution. While it is not possible to compensate most of the original bondholders of Argentine debt in this case, it is likely that CACs and other bondholder cooperation mechanisms will improve chances for better outcomes in the future. CACs may help investors negotiate for better returns in the case of a future default and also eliminate the need for "vulture" funds, which often trade on the losses of other debtors and employ a holdout strategy that can impede movement toward early resolution. Developments that improve investor coordination and more equitable outcomes in future defaults may be a major legacy of the Argentine debt crisis.

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